

Tax Policy and Economic Growth In Nigeria

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Abstract

The Nigerian economy depends on the revenue generated through oil production. However, in recent years the decline in oil prices across the world forced the government to lower domestic oil prices. Consequently, the revenue generation capacity of Nigeria decreased significantly. In view of the prevailing situation, it is important for the government to identify other sources of revenue generation. Thus, we examine the sensitivity of the Nigerian economy on existing tax policies. The study is based on secondary data from 1998 to 2017. The results suggest that the Nigerian government has to focus on revenue generation through direct taxes which are positively associated with economic growth. The results suggest that the government should avoid indirect taxes as it adversely affects economic growth. Moreover, the government must focus on addressing corruption and implement tax reforms. The government may also enhance economic growth by channelizing private savings in productive sectors of Nigeria.

Keywords: *Economic growth, direct taxes, indirect taxes, taxation policy.*

Introduction

The prime objective of economic policy is to stimulate economic growth in a country (Fadare, 2010). Economists have suggested that government investment in infrastructure and social development projects provide employment and stimulate economic growth (Barro & Sala-i-Martin, 1995). On the contrary, it has been argued that increasing government expenditure decreases economic growth and national output. The government may also increase taxes and borrowing for financing development expenditure of a country. However,

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higher taxes may reduce the incentive to work, increase tax avoidance by the workforce and adversely affect the overall investment climate in the economy (Oseni & Onakoya, 2012).

Past studies have investigated the effect of tax policies on economic growth in various economies (Barro & Sala-i-Martin, 1995). It has been documented that many developing countries were able to revive their economies through a well-structured tax system (Barro & Sala-i-Martin, 1995). Moreover, it has also been found that the successful implementation and monitoring of tax policies generate sufficient funds for the government. The judicious spending of tax revenue will generate employment and growth in the country (Niculae & Ciupitu, 2013). Thus, the economic and social development of a country depends on infrastructure spending and generation of resources through a well-functioning tax system. Azubike (2009) argues that an efficient tax system is necessary for generating revenue for the government so that it may fulfil its spending obligations. Appah (2004) also suggests that a tax system is important for mobilizing a country's internal resources and stimulating the rate of economic growth.

It has also been argued that there are five possible mechanisms through which taxes can adversely affect the economic growth of a country (Tosun & Abizadeh, 2005). First, high taxes tend to reduce the private investment in the economy. Second, high income taxes reduce the motivation and willingness of workers. Third, excessive corporate taxes reduce the research and development expenditure of firms. Fourth, high taxes can lead to a diversion of resources to the undocumented sector of the economy. Finally, high taxes reduce the disposable income of workers and the overall consumer spending in the economy. A well-structured tax system if implemented and monitored offers the government an opportunity to generate the required revenue for financing its spending. The sustainable inflow of taxes helps the government to achieve targeted fiscal and macroeconomic goals (Somorin, 2011). Developing countries due to the non-implementation of tax policies are unable to generate wealth and employment which adversely affects the health of the economy (Somorin, 2011).

The tax framework in Nigeria and other economies is based on tax policy, tax law and tax administration. All the components of the tax framework are highly interrelated, therefore, they should be monitored and implemented. The revised Nigerian National Tax Policy of 2016 outlines the framework for a sustainable tax system that would ensure reliable sources of revenue for the government and support the economic development plan. The aim of this policy was to generate economic activities in the country, decrease poverty level and stimulate sustainable economic growth (Azubike, 2009).

Developing economies have two major problems. The first is corruption and the other is low participation of private investors in small and medium projects. Thus, fiscal and

monetary policies in developing economies should address the issue of corruption and encourage small investors to make capital investments. These measures may generate economic activities and sustainable growth (Ergete & Dahlby, 2012).

Previously, the Nigerian government relied on the revenue generated through domestic oil (Otu & Adejumo, 2013). However, oil prices have declined in recent years which has forced the Nigerian government to reduce domestic oil prices. This has reduced the revenue generation capacity of the Federal and State governments (Appah, 2004). Thus, the Nigerian government may not achieve sustainable growth through revenue generation from oil production. The fluctuation in the price of oil has also created concerns for the Nigerian government and reinforced the need to diversify the economy. In view of the above, this paper examines the effect of tax policy on economic growth. More specifically, it investigates the effect of direct taxes, indirect taxes and total tax revenue on economic growth in Nigeria.

Literature Review

Concept of Taxation

Taxes are defined as a compulsory payment to the government imposed by law without any promise of benefits (Appah & Oyandonghan, 2011). The main purpose of taxation is to generate revenues for the government (Jhingan, 2004). Moreover, Anyanfo (1996) suggests that taxes may be imposed by the government to control the production of certain goods and services which are harmful for the society. In addition, taxes are imposed for reducing inequalities in the economy (Bhartia, 2009), curbing inflation (Jhingan, 2004) and the protection of domestic infant industries (Ola, 2001).

The Tax System in Nigeria

The tax system in Nigeria is made up of tax policy, tax law and tax administration (Bhartia, 2009). To achieve the goal of revenue generation, the tax system is expected to minimize distortions in the economy. The Federal Inland Revenue Service (FIRS) is responsible for tax collection at the federal level while the State Inland Revenue Service (SIRS) is responsible at the state level. The Nigerian tax policy 2016 identifies several challenges to the taxation system, i.e. low tax revenue and lack of clarity in taxation policy. Moreover, tax payers do not have sufficient understanding of taxation policy which leads to tax evasion. The current policy is aggressive and promotes orthodox methods of tax collection. The tax system has also failed to honor refund obligations to tax payers.

Economic Growth

Policymakers tend to focus on monetary issues for promoting growth in the economy.

The concept of economic growth has been conceptualized differently by economists (Ola, 2001). For example, Jhingan (2016) defines economic growth as a process which increases the real per capita income of a country. Economic growth is measured by the increase in the amount of goods and services produced in a country. However, Apelogun, Omidia, Salami & Ojoye (2015) suggest that there are two main indicators of economic growth i.e. GDP and NNP. The sustained increase in GDP and NNP make an economy self-sufficient which reduces its reliance on foreign countries support (Shahzad & Maqbool, 2016). Moreover, economic growth can also be defined as the increase in a country's productive capacity measured by comparing the increase in gross national product over the year. The increase in capital stock, technological advancement and improvement in the literacy rate are considered to be key drivers of economic growth. Niculae & Ciupitu (2013) suggest that tax policy becomes effective only if it leads to sustainable GDP growth.

Evidence from Developed Countries

A Canadian study found that a higher corporate tax rate negatively affects economic growth and private sector investment. The authors found that a 1% reduction in the corporate tax increases annual economic growth by approximately 0.2% holding other factors constant. Additionally, the authors found that a change in the retail sales tax regime positively affects the economic growth and investment in Canada (Ergete & Dahlby, 2012).

Baranova & Janickova (2012) investigated the impact of corporate taxes on economic growth in EU countries. The study used a data set for a period of thirteen years from 1998 to 2010. The authors used the neoclassical growth model extended with human capital. The panel data regression analysis suggests a negative relationship between corporate tax burden and long-term economic growth at the 5% level of significance. It was therefore concluded that a rise in the corporate tax burden may lead to a reduction in the long-term economic growth in EU countries. On the other hand, Philippe, Julia, Ufuk & William (2016) examined the effect of taxation and corruption on economic growth. The dataset for the study was obtained from the US Census Bureau. The model predicts an inverted-U shaped relationship between taxation and corruption. On the other hand, the study suggests that corruption has an adverse effect on economic growth.

Evidence from Developing Countries

Aamir et al., (2011) examined the determinants of tax revenue (i.e. direct and indirect taxes) in Pakistan and India. The study used a panel dataset consisting of two countries for the period 2000 to 2009. The results suggest that indirect taxes are a major source of tax revenue in Pakistan whereas direct taxes are a main source of tax revenue in India. Bonu & Pedro (2009) examined the impact of income tax rates on the economic development of Botswana. The study highlights two competing viewpoints on the effect of taxes on

economic growth. The traditional view favors low income tax rates for stimulating economic development, while the contemporary viewpoint stresses high income taxes for driving growth especially in developed countries.

Gale & Samwick (2014) examined the effects of income tax changes on long term economic growth. The authors believe that the structure and financing of a tax change are critical for achieving economic growth. A reduction in tax rates may encourage individuals to work, save and invest. However, lower taxes should accompany lower government spending to avoid a fiscal deficit in the long term. Tax base broadening strategies may eliminate the effect of tax rate reductions on budget deficits. Tax base broadening may also reduce savings and investments. This reduces the rate of economic growth. The results of the study suggest that not all tax changes will have the same impact on economic growth. Tax reforms that improve incentives, reduce existing subsidies and exempt windfall gains will have positive effects on the long term prospects of the economy.

Shahzad & Maqbool (2016) investigate the impact of taxes on economic growth in Pakistan. The study uses annual time series data for the period 1974 to 2010. The Auto-Regressive Distributed Lag (ARDL) bounds testing approach of co-integration was applied to estimate the long run and short run relationships between the variables. The study concludes that total tax revenue has a negative and significant effect on economic growth in the long run. Therefore, the authors recommend that the government should decrease indirect taxes and increase direct taxes to enhance the rate of economic growth.

Evidence from Nigeria

Onalapo, Aworemi & Ajala (2013) investigate the effect of value added taxes on revenue generation in Nigeria. The study uses data from the Central Bank of Nigeria Statistical Bulletin, Federal Inland Revenue Service and the Chartered Institute of Taxation for a period of ten years from 2001 to 2010. The stepwise regression approach was used for data analysis. The results suggest that value added taxes have a statistically significant effect on revenue generation in Nigeria. The authors recommend that the government should improve the administration of value added taxes. Umoru & Anyiwe (2013) examined tax structures and economic growth in Nigeria. The results indicate that direct taxes have a significant and positive impact on economic growth. On the other hand, indirect taxes have an insignificant impact on economic growth in Nigeria. The study also finds that direct taxes contribute heavily to total revenue generation as compared to other sources. Therefore, the government should focus on expanding the direct tax base to enhance the overall tax revenue.

Afubero & Okoye (2014) investigated the impact of taxation on revenue generation in federal capital territory and selected states in Nigeria. The study finds that taxation

has a positive and significant effect on revenue generation and Gross Domestic Product in Nigeria. The study recommends that a database should be established by the federal, state and local governments for maintaining the tax payer information. In addition, the tax collection processes should be corruption free. The government should also modernize the tax administration system in order to enhance tax collection. Adudu & Ojonye (2015) examined the impact of tax policy on economic growth in Nigeria using time series data for a period of twenty years. The Granger-causality test and co-integration technique were applied. The study finds statistical evidence that efficient tax reforms enhance sustainable economic growth. The authors recommend that an improvement in the tax regime and a diversification in the revenue base are necessary for sustainable economic growth.

Jones & Chikezi (2016) investigated the impact of tax reforms on economic growth in Nigeria. The study uses a time series dataset for the period 1985 to 2011. The data was collected from the Central Bank of Nigeria Statistical Bulletin, Federal Inland Revenue Service and the Federal Ministry of Finance. The multiple regression analysis technique was used for data analysis. The results suggest that taxes on petroleum based commodities and corporate taxes have a positive and significant impact on economic growth. They also find that customs and excise duties, value added taxes, personal income taxes and educational taxes have an insignificant impact on the economic growth of Nigeria. The authors conclude that tax reforms have a significant impact on economic growth. Therefore, it is recommended that chartered tax practitioners should play a vital role in the tax reform process. In addition, the government should consider the interests of tax payers and key stakeholders when formulating fiscal and monetary policies. This may encourage greater compliance with tax regulations and help broaden the tax base.

Nwadiakor & Ekezie (2016) explored the effect of tax policy on economic growth in Nigeria. The study used annual time series data from 1994 to 2013. The data was collected from FIRS. Ordinary least squares regression analysis was used to investigate the relationship between direct and indirect taxes and economic growth. The authors observed that the proportion of indirect taxes have increased over time in Nigeria. The results suggest that taxes have a statistically significant effect on economic growth in Nigeria. It is therefore recommended that the government should focus on indirect tax collection due to their non-distortionary nature.

Theoretical Framework

There are several theories of taxation which include the expediency theory, the benefit theory, the cost of service theory, the ability to pay theory and the socio-political theory. All these theories, except the socio-political theory do not consider the role of tax policy in stimulating economic growth and stabilization. The theories do not acknowledge the

importance of taxes in mitigating income inequality, regional disparity in the distribution of resources, unemployment and fluctuations in the economy. The socio-political theory of taxation states that social and political objectives should be carefully considered in developing the taxation framework. The theory states that a tax system should not be designed to serve individuals, but should be focused on addressing the economic problems of a society (Bhartia, 2009). It is argued that tax-driven economic growth will mitigate the social and economic problems such as income inequality, illiteracy and poverty. Therefore, the study has relied on the socio-political theory of taxation in developing the theoretical framework.

Methodology

This study has used a quantitative research design to examine the effect of tax policy on economic growth in Nigeria. A time series dataset was used for the period 1998 to 2017. The data was collected from the statistical bulletin of the Nigeria Bureau of Statistics, Central Bank of Nigeria, Federal Inland Revenue Service and Nigeria Custom Service.

Model Specification

This study has used the economic growth model developed by Ogundana et al., (2017) with some modifications. The original model is as follows:

$$GDP = f(\text{Gross Fixed Capital Formation, Direct Tax, Indirect Tax})$$

The modified model used in the study includes real GDP as the dependent variable and labor as one of the independent variables.

$$RGDP = f(\text{Gross Fixed Capital Formation, Labor, Direct Tax, Indirect Tax})$$

The econometric specification of the model in double log form is as follows:

$$\ln RGDP_t = \beta_0 + \beta_1 \ln GFCF_t + \beta_2 \ln LAB_t + \beta_3 \ln DTAX_t + \beta_4 \ln ITAX_t + e_t$$

The following model was used to examine the effect of total tax revenue on economic growth in Nigeria:

$$\ln RGDP_t = \beta_0 + \beta_1 \ln GFCF_t + \beta_2 \ln LAB_t + \beta_3 \ln TTAX_t + e_t$$

Where,
RGDP = Real Gross Domestic Product
GFCF= Gross Fixed Capital Formation
LAB= Labor
DTAX = Direct Taxes
ITAX = Indirect Taxes
TTAX = Total Taxes
e = error term

Data Analysis

Descriptive and inferential statistics were used to analyze the time series data from 1998 to 2017. The Augmented Dickey-Fuller (ADF) unit root test was conducted to examine the co-integrating relationship between the variables. When co-integration is present an error correction model can be used to explain the short run dynamics. All the time series variables were tested for non-stationarity. The non-stationary time series were made stationary after taking their first differences. Finally, the Autoregressive Distributed Lag (ARDL) model was used.

Results and Discussion

Descriptive Statistics

Table 1 presents the descriptive statistics of the variables used in this study. RGDP ranged from 22.37 trillion to 69.78 trillion. This indicates that RGDP has grown over the past two decades. The average RGDP was 46.27 trillion with a deviation of 17.53 trillion. Similarly, the gross fixed capital formation (GFCF) ranges from 2.14 trillion to a maximum of 11.76 trillion with an average value of 6.26 trillion and a standard deviation of 3.48 trillion. The labor force was measured through the number of working individuals in millions. The average size of the labor force working in Nigeria is approximately 62 million. An average of 1.95 trillion was generated from direct taxes and 0.72 trillion was generated from indirect taxes. This implies that the Nigerian economy generated more tax revenue from direct sources relative to indirect sources. The minimum tax revenue from direct taxes was 0.062 trillion and the maximum was 4.30 trillion. On the other hand, indirect taxes generated a minimum amount of 0.095 trillion and a maximum amount of 1.60 trillion.

Table 1: Descriptive Statistics

	Mean	Max	Min	Std.	Skewness	Kurtosis	Jarque	Observations
			Dev.		Bera stat			
RGDP	46.275	69.781	22.367	17.530	-0.063	1.557	1.748	20
GFCF	6.263	11.776	2.144	3.476	0.174	1.451	2.099	20
LAB	62.000	85.100	43.200	11.700	0.312	2.157	0.917	20
DTAX	1.948	4.297	0.062	1.414	0.246	1.722	1.457	20
ITAX	0.728	1.600	0.095	0.489	0.313	1.645	1.859	20
TTAX	2.676	5.483	0.016	1.864	0.169	1.592	1.747	20

Note: RGDP is Real Gross Domestic Product (Trillion Nairas); GFCF is Gross Fixed Capital Formation (Trillion Nairas); LAB is labor force (number of persons in million); DTAX is direct tax (Trillion Nairas); ITAX is indirect tax (Trillion Nairas) and TTAX is total tax (Trillion Nairas).

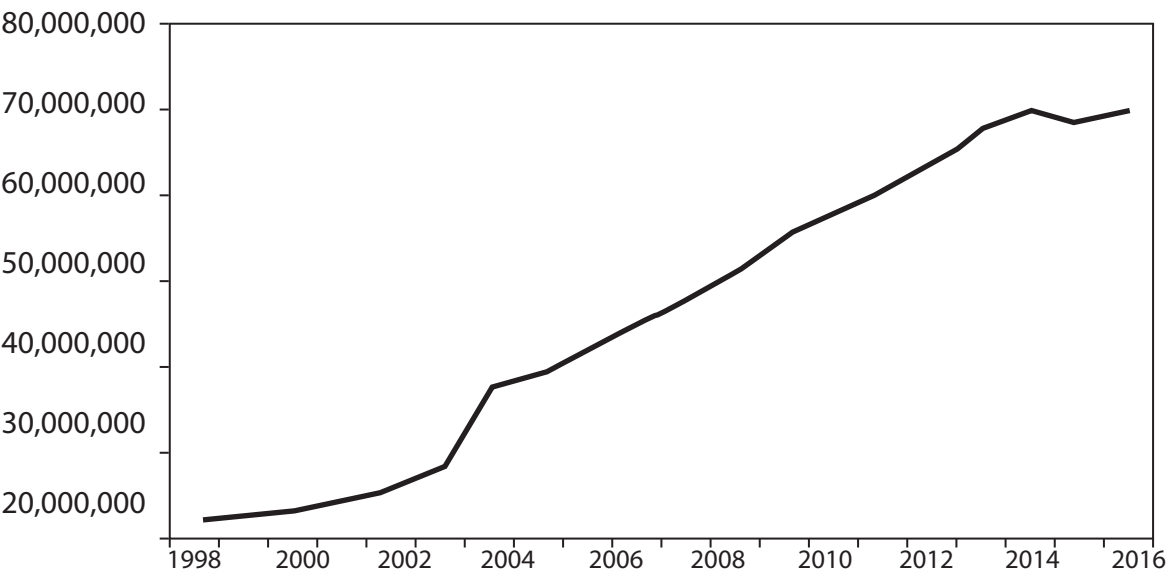


Figure 1: Trend of RGDP

Figure 1 shows the real gross domestic product (RGDP) in Nigeria from 1998 to 2017. The figure suggests that RGDP had increased between 1998 and 2014. There was a decline in RGDP in 2016 which may be due to a recession in 2015-2016. The increase in RGDP may be a result of the sale of crude oil in Nigeria.

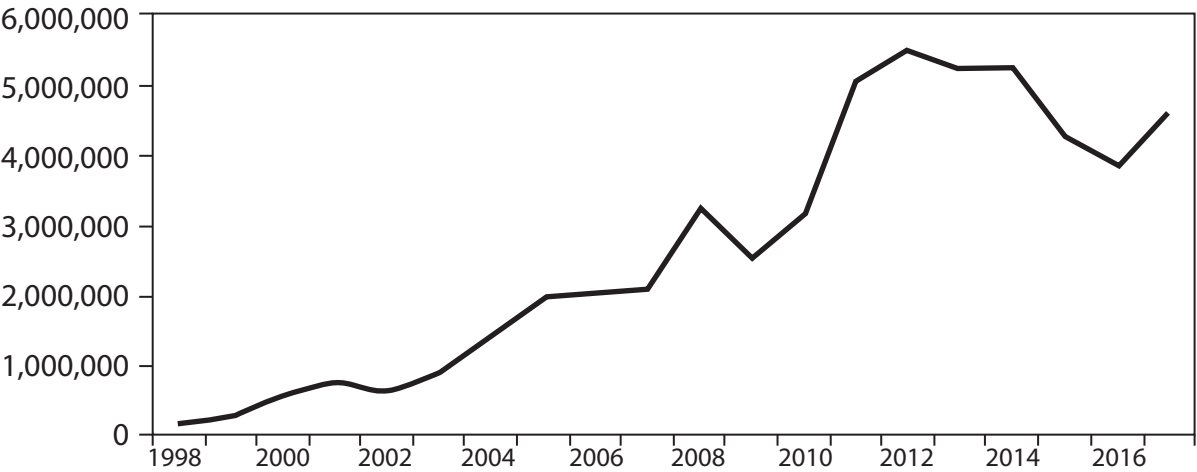


Figure 2: Trend of TTA

Figure 2 shows the total tax revenue (TTAX) of Nigeria from 1998 to 2017. The figure suggests that TTAX had increase from 1998–2001, 2003-2008 and 2010-2012. There was a decline in 2002, 2009, 2013, 2014 and 2016. It was also observed that the total tax revenue had increased during the sample period. The increase in total tax revenue was mainly derived from direct income taxes and indirect taxes levied on petroleum goods.

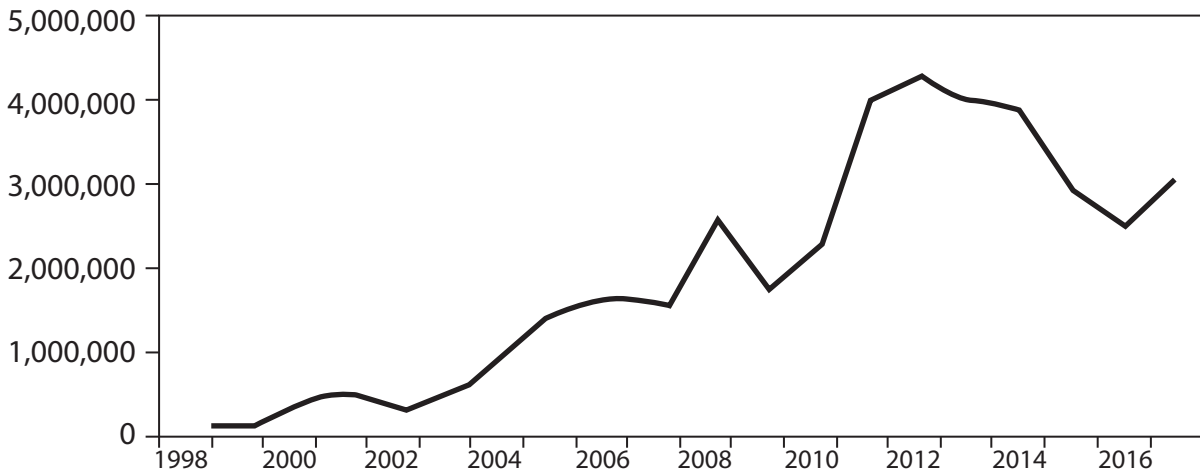


Figure 3: Trend of DTAX

Figure 3 shows the direct tax revenue (DTAX) of Nigeria from 1998 to 2017. The figure suggests that DTAX had increased from 1998-2001, 2003-2006, 2008 and 2010-2012. There was a decline in DTAX in 2002, 2007, 2009 and 2013-2016. It was also observed that the direct tax revenue had increased during the sample period. The increase in direct tax revenue was a result of an increase in corporate taxes.

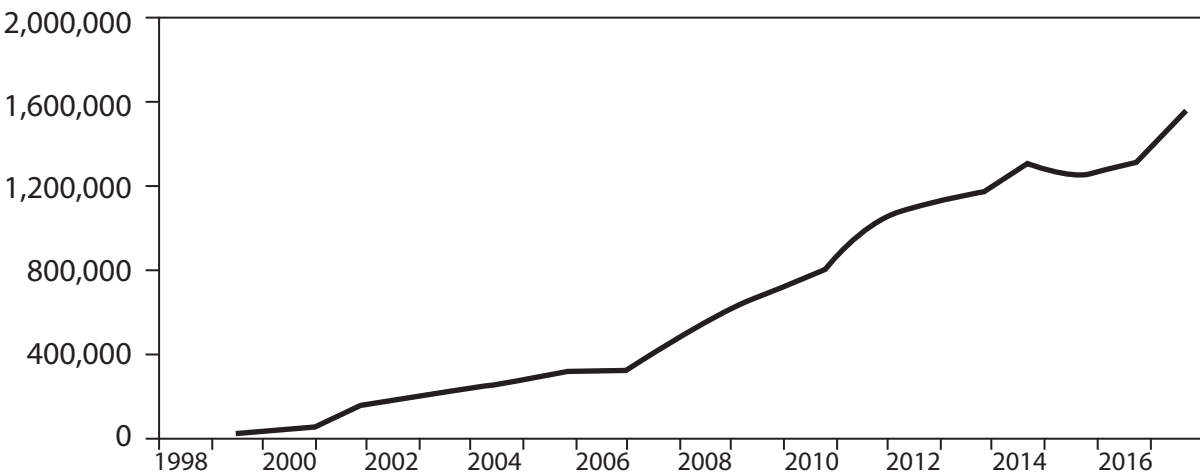


Figure 4: Trend of ITAX

Figure 4 shows the indirect tax revenue (ITAX) of Nigeria from 1998 to 2017. The figure suggests that ITAX had increased from 1998-2005; 2007-2014 and 2016-2017. There was a decline in ITAX in the years 2006 and 2015. It was also observed that the indirect tax revenue had increased for most of the sample period. The increase in indirect tax revenue was a result of an increase in value added taxes, customs and excise duties.

Statistical Results

Unit Root Tests Results

The results from the unit root tests, i.e. the Augmented Dickey-Fuller (ADF) test and Phillips-Perron (PP) test, are presented in Table 2. The results indicate that the log of RGDP, Labor and Gross Fixed Capital Formation are not stationary at all levels. However, after first difference, real RGDP, Labor and Gross Fixed Capital Formation are stationary. This suggests that the series are integrated of order one, i.e. I(1). On the other hand, the test statistics (with constant) show that direct, indirect and total taxes are significant. This implies that the series are stationary, hence, they are integrated of order zero, i.e. I(0).

Table 2: Unit Root Tests Results

	PP test		ADF test	
	With Constant	With Constant	With Constant	With Constant
LNRGDP	-1.2290	-3.5210***	-1.2290	-3.5210***
LNLAB	-0.4637	-3.9578***	-0.4637	-3.9538***
LNGFCF	-0.2074	-6.8553***	-1.6059	-2.5580
LNTAX	-8.5266***	-3.4145**	-3.3465**	-3.4568**
LNINDTAX	-3.6878***	-4.1755***	-3.0266**	-4.1720**
LNDIRTAX	-7.9200***	-3.5731***	-3.4397**	-3.5052**

ARDL Bounds Test Approach of Co-integration

Table 3 reports the results of the autoregressive distributed Lag (ARDL) bounds test approach of co-integration. The F statistics for models 1 and 2 are statistically insignificant which indicates that there is no evidence of co-integration. Therefore, the results do not indicate a long run co-integrating relationship between the variables.

Table 3: ARDL bounds test approach of co-integration

Model	F-statistic	Number of parameters (k)	Maximum lag	Decision
LNGDP =f(LNGFCF, LNLAB, LNDTAX, LNITAX) - Model 1	2.73	4	2	Not co-integrated
LNGDP = f(LNGFCF, LNLAB, TTAX) - Model 2	2.28	3	2	Not co-integrated
			Lower bounds I(0)	Upper bounds I(1)
10%			2.45	3.52
5%			2.86	4.01
2.5%			3.25	4.49
1%			3.74	5.06

Regression Results

Table 4 shows the short-run and long-run impact of direct, indirect and total tax on economic growth in Nigeria. The residuals of both models (model 1 & 2) are normally distributed and do not suffer from serial correlation and heteroskedasticity. This implies that both models satisfy the regression model assumptions. In addition, R-squared values are 0.99 and 0.98 for Model 1 and Model 2 respectively. The R-squared values indicate that both models have a good fit. The significant F-statistics suggest that the models are statistically significant.

Table 4: Regression Results showing the effect of Tax policy on Economic Growth in Nigeria

SHORT RUN	MODEL 1	MODEL 2
LNRGDP(-1)	0.448	0.607*
LNGFCF(-1)	0.0115**	
LNGFCF	0.0011	0.047
LNLAB(-1)	0.0190	
LNLAB	-0.0592	0.033
LNDTAX (-1)	0.0030	
LNDTAX	0.0037***	
LNITAX (-1)	0.0038	
LNITAX	-0.0299**	
LNTTAX		0.130**
CointEq(-1)	-0.228**	4.183**
LONG RUN	MODEL 1	MODEL 2
LNGFCF	0.0227***	0.121
LNLAB	0.1134	0.084
LNDTAX	0.0089***	
LNINDTAX	-0.0348	
LNTTAX		0.331**
Constant	-0.4137*	10.658*
R-squared	0.99	0.98
Adjusted R-squared	0.99	0.98
F-statistic	252.83***	256.48***
Prob (F-statistic)	0.0000	0.0000

Note: ***, ** and * represents statistical significance at the 1%, 5% and 10% levels respectively.

The results of the study suggest that direct taxes have a positive and significant impact on economic growth in both the short and long-run in Nigeria. The positive effect of direct taxes on economic growth is consistent with the theory and previous research (Umoru & Anyiwe, 2013; Okoh, Onyekwelu & Iyidiobi, 2016; Jones & Chikezi, 2016; Cornelius, Ogar & Arikpo, 2016; Okwara & Amori, 2017). On the other hand, indirect taxes have a negative and significant effect on economic growth in the short-run and insignificant effect on the

economic growth in the long-run. This implies that indirect taxes such as value added taxes and customs & excise duties have not been very effective in enhancing the long term economic growth in Nigeria. The negative and insignificant effect of indirect taxes on the long-run economic growth is consistent with the previous research (Umoru & Anyiwe, 2013; Jones & Chikezi, 2016; Abiola, & Asiweh, 2012; Okwara & Amori, 2017). Overall, total tax revenue has a statistically significant positive impact on economic growth in the short and long-run. The results are consistent with the findings of Afuberoh & Okoye (2014) and Okwara & Amori (2017).

Conclusion and Recommendations

The serious decline in the international market price of oil in recent times has led to a decrease in the funds available for distribution to the federal, state and local governments in Nigeria. Consequently, the dependence on oil as the main source of revenue in Nigeria has created concern for sustainable economic growth. The fall in oil prices has adversely affected the total tax collection and created pressure for the Nigerian government to diversify its sources of revenue. Globally, capital and labor are the key determinants of economic growth in the country. However, tax revenue comprising both direct and indirect taxes are also prominent factors behind the rate of economic growth. The study examines the relationship between tax revenue and economic growth in Nigeria.

The results of this study suggest that direct and total taxes have a positive and statistically significant effect on economic growth. On the other hand, indirect taxes have a negative and significant effect on economic growth in the short-run and insignificant effect on the economic growth in the long run. This implies that indirect taxes such as value added taxes and customs & excise duties have not been very effective in enhancing the long term economic growth in Nigeria. Thus, it is imperative for the Nigerian government to strengthen the tax system to enhance total tax collection and economic growth.

Based on the results of the study, several recommendations are provided to the government, policy makers, tax administrators and tax practitioners. First, the government should strengthen the administration of direct taxes since it has positive and significant effect on the economic growth. Second, the government should focus on indirect taxes to increase revenue collection with low administrative costs and compliance challenges. Third, the government should review the Nigerian tax law in order to improve the level of compliance and increase the total number of taxpayers.

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